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Reducing the legal obstacles faced by micro, small and medium-sized enterprises (MSMEs)

Note by the Secretariat

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Introduction

1. At its twenty-sixth session (April 2016), the Working Group considered document A/CN.9/WG.I/WP.92 (paras. 86 to 88, A/CN.9/866) which had been prepared by the Secretariat to provide the overall context for work prepared by the United Nations Commission on International Trade Law (UNCITRAL) in respect of micro, small and medium-sized enterprises (MSMEs). While the Working Group did not have sufficient time to consider A/CN.9/WG.I/WP.92 in detail, there was broad support for the proposal that a document along those lines could accompany its MSME work as an introduction to the final text and that it could provide an overarching framework for UNCITRAL's current and future work on MSMEs. Further, the Working Group was of the view that, once specifically considered and adopted by the Working Group and the Commission, that contextual framework could be underpinned by legal standards that would provide legislative pillars to the framework; importantly, such an approach could accommodate expansion through the addition of other legislative texts regarding MSMEs as such texts might be adopted by the Commission. Those views were noted by the Commission at its forty-ninth session (2016), at which the Working Group was commended for the progress that it had made on its work to date.[1]

2. This working paper is a revised version of A/CN.9/WG.I/WP.92 (and its update, A/CN.9/WG.I/WP.107, which there was insufficient time to consider at the twenty-ninth session of the Working Group), taking into account the general views expressed by the Working Group at its twenty-sixth session (paras. 86 to 88, A/CN.9/866), as well as appropriate material drawn from the contribution by the United Nations Conference on Trade and Development (UNCTAD) in document A/CN.9/WG.I/WP.98. Necessary amendments have also been made in light of the development by the Working Group of the draft legislative guides on key principles of a business registry (A/CN.9/WG.I/WP.109) and on an UNCITRAL limited liability organization (A/CN.9/WG.I/WP.99 and Add.1).

I. Micro, small and medium-sized enterprises (MSMEs)

3. At its forty-sixth session, in 2013, UNCITRAL decided to commence work on reducing the legal obstacles faced by MSMEs throughout their life cycle, and in particular, specified that such work should focus on MSMEs in developing economies. This matter was placed on UNCITRAL's work programme for Working Group I, which was requested to begin work on its mandate with a focus on the legal questions surrounding the simplification of incorporation.[2] In taking up this topic, UNCITRAL has decided to focus its attention, at least initially, on the reduction of legal obstacles that MSMEs face at the beginning of their life cycle.

4. In light of the disadvantaged position in which many MSMEs are found globally, undertaking this work emphasizes the relevance and importance of UNCITRAL's work and programmes for the promotion of the rule of law at the national and international levels and for the implementation of the international development agenda. These include the achievement of the Sustainable Development Goals, which build upon the successes of the Millennium Development Goals, and which specifically note the encouragement of the formalization and growth of MSMEs in target 3 of goal 8 to "Promote inclusive and sustainable economic growth, employment and decent work for all". The global community has recognized both the importance of fair, stable and predictable legal frameworks for: generating inclusive, sustainable and equitable development, economic growth and employment; stimulating investment; and facilitating entrepreneurship, as well as UNCITRAL's contribution to the attainment of those goals through its efforts to modernize and

[1] *Official Records of the General Assembly, Seventy-first Session, Supplement No. 17* (A/71/17), paras. 222 and 224.

[2] Ibid., *Sixty-eighth Session, Supplement No. 17* (A/68/17), para. 321.

harmonize international trade law.[3] Work aimed at supporting and fostering the establishment and growth of MSMEs further underpins UNCITRAL's contribution in providing internationally acceptable rules in commercial law, and supporting the enactment of those rules to assist in strengthening the economic fibre of States.

5. The international community has underscored the importance of business law as one of four pillars key to strengthening the legal empowerment of the poor, many of whom rely upon micro and small businesses for their livelihood.[4] In addition to other pillars (such as access to justice and the rule of law; property rights; and labour rights), business rights are seen as important to empower the less advantaged, not only in terms of their employment by others, but in developing micro and small businesses of their own. Business rights may be regarded as a composite of existing rights of groups and individuals to engage in economic activity and market transactions, and which include the right to start a business in the legally regulated economy without facing arbitrarily enforced regulations or discrimination, removing unnecessary barriers that limit economic opportunities, and protecting business investments, regardless of their size.[5] Measures that have been called for to strengthen business rights include:

(a) Guaranteeing basic business rights, including the right to sell, the right to have a workspace and the right to have access to the necessary infrastructure and services (for example, to electricity, water and sanitation);

(b) Strengthening, and making effective, economic governance in order to permit entrepreneurs to easily and affordably establish and operate a business, to access markets, and to exit a business;

(c) Expanding the accessibility of entrepreneurs to limited liability entities and to other legal mechanisms that allow owners to separate their business and personal assets;

(d) Promoting inclusive financial services that offer savings, credit, insurance, pensions and other tools for risk management; and

(e) Expanding the access of entrepreneurs to new business opportunities through specialized programmes to familiarize entrepreneurs with new markets, assisting them in creating links with other businesses of all sizes, and in complying with regulations and requirements.[6]

6. UNCITRAL's experience in developing international trade law texts may assist in the identification of the legal and regulatory framework that can best assist entrepreneurs and MSMEs in establishing business rights, thereby reducing some of the legal obstacles that such businesses face.

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[3] See, for example, "Declaration of the High-level Meeting of the General Assembly on the Rule of Law at the National and International Levels", United Nations General Assembly resolution A/RES/67/1 (67th session, 2012), para. 8, and "Addis Ababa Action Agenda of the Third International Conference on Financing for Development (Addis Ababa Action Agenda)", United Nations General Assembly resolution A/RES/69/313 (69th session, 2015), Annex, para. 89.

[4] See, for example, "Making the Law Work for Everyone", Volume I, Report of the Commission on Legal Empowerment of the Poor (2008) (downloadable at https://www.un.org/ruleoflaw/blog/document/making-the-law-work-for-everyone-vol-1-report-of-the-commission-on-legal-empowerment-of-the-poor/). The findings of this Commission formed an integral part of the United Nations Development Programme's (UNDP) Initiative on Legal Empowerment of the Poor (www.undp.org/content/undp/en/home/ourwork/democraticgovernance/focus_areas/focus_justice_law/legal_empowerment.html) and have contributed to similar work on Legal Empowerment of the Poor in international organizations such as the World Bank Group.

[5] Ibid., pp. 30–31.

[6] Ibid., pp. 8–9.

A. The importance of MSMEs in the global economy

7. UNCITRAL's decision to work on reducing the legal obstacles faced by MSMEs recognizes the importance of such enterprises to the economic health of the States in which they are found, and to the global economy more generally. This importance is underscored by a number of key facts that illustrate that MSMEs are seen as the backbone of the economy in both the developed and the developing world.

8. The total number of MSMEs worldwide is estimated to be around 500 million, of which approximately 85 per cent are in emerging markets.[7] Statistics for small and medium-sized enterprises (SMEs), a subset of MSMEs, indicate that such businesses account for over 70 per cent of total employment and 64 per cent of Gross Domestic Product (GDP) in developed economies, and approximately 45 per cent of employment and 63 per cent of GDP in low-income countries.[8]

9. It may also be instructive to review some of the statistics on such enterprises on a regional and subregional basis. In the European Union (EU), over 95 per cent of all businesses are SMEs, which provide two out of three private sector jobs and contribute to more than half of total value-added created by business in the EU. Further, nine out of ten SMEs in the EU are microenterprises (defined in the EU as enterprises having fewer than 10 employees), thus illustrating that the mainstays of Europe's economy are micro firms.[9]

10. Microenterprises are no less influential in other developed States. Over 90 per cent of all businesses in the United States of America are microenterprises (defined in the United States as enterprises having fewer than 5 employees, including the owner). The direct, indirect and induced effect of microenterprises have an impact on over 40 million jobs in the United States: directly accounting for over 25 million jobs; indirectly supporting close to 2 million jobs through business purchases; and having an induced effect (through the personal purchasing power of owners and employees of microbusinesses) on over 13 million jobs.[10]

11. MSMEs are also of great importance in regions of the world where a large number of developing States are found. In the Caribbean Community and Common Market (CARICOM), MSMEs provide more than 50 per cent of GDP and account for around 70 per cent of jobs,[11] while in Latin America, MSMEs provide employment to about 70 per cent of the regional workforce and contribute almost 50 per cent of the region's GDP.[12] Statistics available for SMEs, a subcategory of MSMEs, are no less impressive: in the Association of Southeast Asian Nations (ASEAN) region, they represent over 95 per cent of all enterprises and contribute approximately 50 per cent of GDP;[13] in Asia-Pacific Economic Cooperation (APEC) economies, SMEs account for over 95 per cent of all businesses and employ over half of the work force;[14] and

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[7] World Bank Group Study, http://www.worldbank.org/en/topic/financialsector/brief/smes-finance

[8] "IFC Jobs Study: Assessing Private Sector Contributions to Job Creation and Poverty Reduction", 2013, pp. 10–11 (https://www.ifc.org/wps/wcm/connect/0fe6e2804e2c0a8f8d3bad7a9dd66321/IFC_FULL+JOB+STUDY+REPORT_JAN2013_FINAL.pdf?MOD=AJPERES)

[9] See European Commission's Annual report on European SMEs 2015/16: SME recovery continues (https://ec.europa.eu/jrc/sites/jrcsh/files/annual_report_-_eu_smes_2015-16.pdf)

[10] See, for example, "Bigger than you think: The Economic Impact of Microbusinesses in the United States", Association of Enterprise Opportunity (AEO), September 2014 (http://microenterprisealabama.org/wp-content/uploads/2014/09/Bigger-Than-You-Think-The-Economic-Impact-of-Microbusiness-in-the-United-States-copy.pdf)

[11] See www.oas.org/en/media_center/press_release.asp?sCodigo=E-061/12

[12] Available at www.informeavina2008.org/english/develop_case2_SP.shtml

[13] P. Manawanitkul, Enabling Environment for Microbusiness — ASEAN Experience, Presentation delivered at the International Joint Conference on "Enabling Environment for Microbusiness and Creative Economy", organized by UNCITRAL, the Ministry of Justice in the Republic of Korea and the Korean Legislation Research Institute, Seoul, 14–15 October 2013

[14] See www.apec.org/Groups/SOM-Steering-Committee-on-Economic-and-Technical-Cooperation/Working-Groups/Small-and-Medium-Enterprises.aspx

in Africa, they provide more than 45 per cent of employment and contribute over 30 per cent of GDP.[15]

B. Defining MSMEs

12. There is no standardized international definition of what constitutes an MSME, since each economy will define its own parameters for each category of business size by taking into account its own specific economic context. For the purposes of work undertaken by UNCITRAL, it is not necessary or advisable to seek consensus on a definition for each category of MSME, since any legislative texts produced will be applied by States or regional economic groups to MSMEs in accordance with their own definitions, based on each unique economic context. The important common factor from State to State is that MSMEs, regardless of how they are defined, are enterprises that, by virtue of being the smallest and most vulnerable, face a number of common obstacles irrespective of the particular jurisdiction in which they are found. For that reason, these materials do not offer guidance on how a State should define the different categories of MSMEs.[16]

C. The nature of MSMEs

13. MSMEs are incredibly varied in nature. They may consist of sole entrepreneurs, small family businesses or larger enterprises with several or many employees, and may operate in virtually any commercial sector, including in the service industry and the artisanal and agricultural sectors.

14. Moreover, MSMEs may be expected to vary depending on the local economic conditions, cultural traditions and the different motivations and characteristics of the entrepreneurs establishing them. Enterprises that operate in the legally regulated economy may also take various legal forms, depending on the options available to them under applicable law, and on how those different forms may meet their needs.

15. In addition, although MSMEs may be seen, particularly in the context of developing economies, mainly as a source of livelihood for the working poor, such enterprises need not be static; in fact, MSMEs may also serve a dynamic purpose as a source of entrepreneurial talent in an economy. Indeed, their importance in the world economy suggests that providing for and fostering the growth of MSMEs is a key goal in order to achieve economic progress, innovation and success.

16. However, despite their disparate nature, certain characteristics of MSMEs may be broadly shared, including:

(a) Small size; they are and remain small operations;

(b) Disproportionate impact of burdensome regulatory hurdles;

(c) Reliance on family and friends for loans or risk-sharing;

(d) Limited access to capital or to banking services;

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[15] See the African Development Group News and Events page, "The AfDB SME Program Approval Boosting Inclusive Growth in Africa", 2013, available at www.afdb.org/en/news-and-events/article/the-afdb-sme-program-approval-boosting-inclusive-growth-in-africa-12135.

[16] States may wish to note the definitions of the different categories of businesses included in MSMEs that have been established either by various States or by regional economic groups. Those definitions tend to be based on a number of elements, considered separately or along with other factors, including: (i) the number of employees at a specific point in time, such as the end of the financial or calendar year; (ii) the amount of annual revenue or turnover generated by the enterprise, or the balance sheet total of the business; (iii) the asset base of the business; (iv) the total monthly wages paid by the enterprise; or (v) the amount of capital invested in the enterprise.

(e) Limited source of employees; if any, they are often drawn from family and friends and may be unpaid and unskilled, including having limited administrative capacity;

(f) Limited markets; these may comprise only relatives, close friends and local contacts;

(g) Vulnerability to arbitrary and corrupt behaviour;

(h) Limited access to dispute settlement mechanisms, which puts them at a disadvantage in disputes with the State or with larger businesses;

(i) Lack of ability to partition assets, so business failure often means that personal assets are also lost;

(j) Vulnerability to financial distress; and

(k) Difficulty in transferring or selling a business and in profiting from both tangible and intangible assets (such as client lists or relationships with customers).[17]

D. Creating sound business environments for all businesses

17. Efforts to assist MSMEs at the start of their life cycle might first begin with consideration of the business environment in which an MSME will be conducting its affairs. A "business environment" may be defined in a number of different ways, but could be said to comprise the policy, legal, institutional and regulatory conditions that govern business activities, and the administration and enforcement mechanisms established to implement government policy, as well as the institutional arrangements that influence the way key actors operate. These key actors may include government agencies, regulatory authorities, business organizations, trade unions, and civil society organizations. All of these factors affect business performance.[18]

18. Sound business environments can have a positive influence on economic growth and poverty reduction. While views differ as to the significance and measurability of the link between the business environment, on one hand, and economic growth and poverty reduction, on the other, poor business environments are unlikely to provide sufficient incentives and opportunities for entrepreneurs to carry on their commercial activities in the legally regulated economy. In addition, poor business environments tend to be more susceptible to corruption and usually have a disproportionate gender impact, since the businesses most vulnerable in a weak business environment are micro-businesses, which are often owned by women.[19]

19. It should be noted that the quality of the business environment varies not only as between States, but also within the different regions of those States. Such regional variations make it unlikely that a single solution will provide the answer for improving the business environment in every State. Similarly, the challenges faced by MSME entrepreneurs vary depending on the context in which they are doing business. However, the two concepts are linked, since many of the challenges faced by MSMEs are similar to those considered detrimental to a favourable business environment in general, including: burdensome regulation, high economic inequality, low institutional quality, low quality of public infrastructure, and a lack of access to credit and other resources.[20]

20. Improving the quality of the business environment and assisting MSMEs in overcoming the particular challenges facing them often require a State to take

[17] See, for example, supra note 4, pp. 8–9, 38–39 and 70–73.

[18] Donor Committee for Enterprise Development (DCED), 2008, "Supporting Business Environment Reforms", p. 2.

[19] Ibid, p. 3; see also, "Making the Law Work for Everyone", Volume I, Report of the Commission on Legal Empowerment of the Poor, supra note 4.

[20] See K. Kushnir, M. L. Mirmulstein and R. Ramalho, "Micro, small and medium enterprises around the world: How many are there, and what affects their count?", 2010, World Bank/IFC.

measures towards legal and policy reform. These reforms may include, among others, providing for a simple and effective system of registration with those public authorities with which a business may be required to register (which may include the business or commercial registry, as well as taxation and social security authorities), as well as providing for a range of simplified and flexible legal forms for business so as to meet the varied needs of MSMEs. States most often initiate such reforms in order to: facilitate business start-up and operations, stimulate investment opportunities, and increase growth rates and employment. Such reforms require careful planning and commitment on the part of the State, as well as the involvement of many different entities at various administrative and governmental levels.[21]

II. The extralegal economy

21. As outlined above in paragraph 16, MSMEs generally face a number of key challenges, some of which are caused, and many of which are exacerbated, by operating in the extralegal economy,[22] also referred to as the "informal" economy. While developing States host over 85 per cent of the large number of MSMEs in business globally, an estimated 77 per cent of them operate in the extralegal economy.[23] Statistics for SMEs (a subset of MSMEs) that are operating in the extralegal economy indicate that such businesses are estimated to provide over 45 per cent of all jobs in developing States and 25 per cent in developed States, but that they account for only around 35 per cent and 15 per cent of the GDP, respectively, in those economies.[24]

22. "Informality" is by no means a uniform concept. Many businesses that might be considered "informal" actually operate in fixed premises and according to locally accepted commercial rules. In addition, they may be well-known by local authorities, pay some form of local taxes, and may even engage in cross-border trade. Others, on the other hand, may have little interaction with the State.

23. Although measurement tools are imperfect and no clear boundaries exist between formal (or legally regulated) and informal (or extralegal) sectors, businesses can be viewed as operating on a formality-informality (or legal-extralegal) spectrum, according to the extent to which their operations fall within the ambit of a State's official laws or take place outside its official structures. Reference in these materials to the "legally regulated economy" thus refers to the sector of the economy characterized by activities that are conducted within the ambit of formal regulation and structure, and commercial activity that falls outside of this scope will be referred to as "extralegal" rather than "informal". Moreover, since the entry point for businesses wishing to access the legally regulated economy is often by way of mandatory registration with certain public authorities (often the commercial or business registry, as well as taxation or social security authorities), extralegal enterprises will refer to those that have not complied with mandatory registration with the authorities as required by the applicable law of the State. Mandatory registration with those public authorities will be considered in these materials to be the main conduit through which businesses are encouraged to operate in the legally regulated economy. However, it should be noted that in some States, certain businesses (due to their size and legal form) are not required to register with the business registry, taxation or social security authorities and provided those businesses fulfil other

[21] See Donor Committee for Enterprise Development (DCED), Supporting Business Environment Reforms: Practical Guidance for Development Agencies, Annex: How Business Environment Reform Can Promote Formalisation, 2011.

[22] See, for example, A. M. Oviedo, M. R. Thomas, K. K. Ozdemir, Economic Informality: causes, costs and polices — a literature survey, 2009, pp. 14 et seq.

[23] Supra, note 7.

[24] Supra, note 8.

mandatory requirements, they are regarded as operating in the legally regulated economy.[25]

24. In addition, the extralegal economy is not related to illegal or criminal activity. Illegal activities are contrary to the law, but informal activities are extralegal, in that they are not officially declared and occur outside the legal and regulatory regime that should govern such activities. The discussion in these materials is limited to extralegal commercial activities and does not address illicit trade in goods or services.

25. Further, extralegal commercial activity may be mainly of a different nature in some States, such as in developed economies. In such States, the extralegal economy may consist mainly of formal firms and workers that underreport their income to tax authorities, or that use undeclared labour in certain business domains.[26] These types of extralegal activities are not the focus of these materials.

26. It is also important to note that although extralegal commercial activity, particularly in the developing world, may exist largely as a result of economic necessity (as noted above in respect of MSMEs in general)[27] components of the extralegal economy may also be seen as quite dynamic and as an incubator for business potential that in fact provides economies with a large number of potential contributors to business development. In fact, businesses operating in the extralegal economy may be seen to provide a pool of talent and an important base of operations from which entrepreneurs can access, and graduate into, the legally regulated economy. There is increasing recognition that the extralegal sector is growing and that it should not be considered a marginal or peripheral sector, but rather as an important building block of a State's overall economy.[28]

27. In fact, a majority of the world's working population operates in the extralegal economy; that number is projected to grow to two-thirds of the global work force by 2020.[29] Although the very nature of such enterprises prevents the identification of precise statistics, estimates of the regional prevalence of extralegal economic activity as a percentage of GDP are as follows: 38 per cent in sub-Saharan Africa; 18 per cent in East Asia and the Pacific; 36 per cent in Europe and Central Asia; 35 per cent in Latin America and the Caribbean; and 27 per cent in the Middle East and North Africa. By way of comparison, the level of the extralegal economy as a percentage of GDP is estimated at 13 per cent in high-income Organisation for Economic Co-Operation and Development (OECD) States, and at 17 per cent globally.[30]

28. The institution of reforms to improve the business environment, as noted above in paragraphs 17 to 20, may encourage and facilitate the operation of enterprises in the legally regulated economy. However, in order to achieve success, policies encouraging businesses to operate in that economy should take into account the different motivations and characteristics of entrepreneurs operating in the extralegal sector, and ensure sufficient incentives are offered to encourage them to operate in the legally regulated economy. An entrepreneur's reasons for operating a business in the extralegal sector will vary depending on the economy, but may include: high entry barriers and costs (including taxes and other social contributions) that outweigh the benefits that can be expected from entering the legally regulated economy; lack of

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[25] Further to the request of the Working Group at its twenty-ninth session, the Secretariat has clarified throughout this text that the operation of a business in the legally regulated economy refers to a business that has complied with the system of mandatory registrations and other requirements of the jurisdiction in which it operates (para. 22, A/CN.9/928).

[26] Supra, note 23, pp. 6 et seq.

[27] See para. 15 above.

[28] See, for example, UNCTAD's information on business facilitation (www.businessfacilitation.org/topics/formalization/).

[29] "How to formalize the informal sector. Make formalization easy and desirable", UNCTAD, (www.businessfacilitation.org/topics/formalizing-the-informal-sector.pdf).

[30] "Economic Developments in Africa Report, 2013. Intra-African Trade: Unlocking Private Sector Dynamism", UNCTAD, pp. 65–66 (http://unctad.org/en/PublicationsLibrary/aldcafrica2013_en.pdf).

information required to access the legally regulated economy; and a lack of job opportunities in the legally regulated economy.[31]

29. Variations in the size and characteristics of the extralegal economy are also apparent from region to region. An analysis of one region, for example, indicates high levels of extralegal commercial activity, partially due to the fact that the extralegal economy is where most new jobs are found, and where many entrepreneurs must trade by necessity.[32] In this region, a job, an enterprise and a household are often the same thing,[33] and lack of entrepreneurial skills, access to credit, and infrastructure are seen as the most obvious constraints to growth. In other regions, the extralegal sector tends to behave like a typical small business sector, and is often the main entry point for young, uneducated workers seeking employment, as well as for those seeking part-time work.[34] Other regions have experienced growth of the extralegal economy in recent years, apparently driven by a lack of jobs in the legally regulated sector and reduced demand for goods and services from those employed in that sector.[35]

30. The debate on the reasons for the extralegal sector, on its effect on national economies and on how to approach the issue has been vibrant for decades and has in recent years had a major influence on policymaking. The view that extralegal commercial activity is the result of burdensome regulation and costly procedures required by the State for businesses to enter the legally regulated economy, and that a reduction of those barriers will help extralegal MSMEs move towards a higher degree of compliance with mandatory registration requirements, has generated strong momentum for reforming regulations and laws in order to simplify business entry into the legally regulated economy.[36] A wide array of policies has been designed and implemented in several States and regions of the world, since, as noted earlier, the variable nature of the extralegal sector, and the different levels of development of States, render elusive the identification of a single optimal approach. The most successful interventions have been comprehensive policy packages aimed at achieving various goals, such as economic growth, social protection and inclusion, and which often include:

(a) Reducing the costs of a business entering and operating in the legally regulated sector, which include entry costs, taxes, fees and social contributions, and costs of compliance;

(b) Improving the benefits of operating in the legally regulated economy by reducing the bureaucracy and expense involved in obtaining fixed premises, and providing access to business development services and new markets;

(c) Improving the general business environment, so that policies to reduce costs and to improve the benefits of entering the legally regulated economy also assist firms already operating in that sector; and

(d) Strengthening the enforcement of a State's legal regime in order to encourage operation in the legally regulated economy.[37]

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[31] M. Jaramillo, "Is there demand for formality among firms?", Discussion paper, 2009, pp. 2 et seq. see also "Enterprise Surveys — Enterprise Note Series. Formal and Informal Microenterprises", World Bank Group, Enterprise Note No. 5, 2009.

[32] See Sub-Saharan Africa, United Nations Industrial Development Organization (UNIDO), GTZ, 2008, Creating an enabling environment for private sector development in sub-Saharan Africa, p. 16.

[33] See Sub-Saharan Africa, Donor Committee for Enterprise Development (DCED), 2009, Business Environment Reforms and the Informal Economy — Discussion Paper, p. 2.

[34] See Latin American and Caribbean States, Donor Committee for Enterprise Development (DCED), 2009, Business Environment Reforms and the Informal Economy — Discussion Paper, p. 2.

[35] See Asia and southeast Europe, Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ), website, Toolkit: Learning and Working in the informal economy, www.giz.de/expertise/html/10629.html.

[36] Supra, note 31, pp. 2 et seq.

[37] International Labour Organization (ILO), GIZ, Enterprise formalization: fact or fiction?, A quest for case studies, 2014, p. 24.

III. Ensuring that operation in the legally regulated economy is simple and desirable for MSMEs

31. In order to encourage MSMEs to operate their business in the legally regulated economy, States may wish to consider how best to effectively convey to MSMEs the availability of and the advantages offered by that approach. In addition, States should also consider what steps they can take to motivate such behaviour by making it a desirable, easily accessible process, that will impose the least burden possible on the MSME.

A. Explaining the meaning of operating in the legally regulated economy

32. To ensure widespread understanding of the advantages available to MSMEs, steps must be taken to explain the meaning of participating in the legally regulated economy and to provide clear and accessible information on how to achieve that aim. The State should consider how best to effectively convey relevant information to MSMEs, including on the necessary requirements in their jurisdiction and how such businesses can fulfil them, and any other information necessary for them to operate in the legally regulated economy. In addition to advising on the benefits of operating in the legally regulated economy, information should also be provided on the types and advantages of the legal forms that are available to a business, and the public authorities with which registration might be necessary (e.g. business registration, taxation and social security authorities). Ideally, a business should be able to use a single physical or electronic interface (a "one-stop shop") to register simultaneously with all necessary public authorities. Information in respect of these matters should be specifically adapted so that it is tailored to and clear and easily understandable by the target audience.

1. The advantages of the legally regulated economy

33. Part of the message that must be conveyed to MSMEs in order to persuade them to operate their businesses in the legally regulated economy is an explanation of the advantages of that approach. These advantages are outlined below.

(a) Advantages for the State

34. States have a clear interest in encouraging MSMEs to operate in the legally regulated economy. One of the reasons often cited for that interest is in terms of taxation, since encouraging MSMEs to operate in the legally regulated economy will broaden the tax base of the State.[38] It may also help reduce any friction that may exist with enterprises already operating in the legally regulated economy and paying taxes, but that must compete for market share with extralegal businesses. Additional reasons for a State to take action to encourage businesses to operate in the legally regulated economy, may include, depending upon the specific economic sector, ensuring consumer protection and, in general, engendering trust in business and commerce in the State for stakeholders including consumers, business partners and banks.

35. Other advantages to the State may be less direct, but are no less valuable. For example, providing previously extralegal businesses with the means to enter the legally regulated economy will permit those MSMEs to grow, to create jobs, and to increase their earnings and contribution to the creation of wealth and the reduction of poverty in the State. Businesses that operate in the legally regulated economy can be expected to attract more qualified employees and to stay in business longer, thus making investment in the training of personnel and the acquisition of capital more

[38] States may wish to note that reduced taxation rates and administration may be an incentive offered to MSMEs to join the legally regulated economy, and that too great an emphasis on expanding the tax base might be counterproductive

profitable. The increase in the number of businesses that comply with mandatory registrations will mean that there is more and better economic data available, that more information will be exchanged in respect of such businesses and that information will become more transparent. All of these effects will have an overall positive impact on the economy of the State.[39]

(b) Advantages for entrepreneurs

36. States must also ensure that they convey clearly and effectively to MSMEs and entrepreneurs the benefits of doing business in the legally regulated economy. The following factors are often cited as key advantages for MSMEs that operate in that commercial context.

(a) Visibility to the public and to markets

Registering a business with public authorities, including mandatory or non-mandatory registration in the business registry, can be a primary means through which the business becomes visible to the public and to markets, thus providing a means for exposure to potential clients and business contacts, and an expansion of market opportunities. This membership in the marketplace may provide opportunities to become a supplier of goods and services under favourable conditions, and can dramatically improve the profitability of the business. Moreover, such visibility both reduces the costs of and enables MSMEs to trade in economic circles beyond their relatives, friends and local contacts, thus opening up new markets.

(b) Visibility to the banking system and financial institutions

Registration with public authorities, including mandatory or non-mandatory business registration, can also provide an enterprise with improved access to banking and financial services, including to bank accounts, loans and credit. This permits MSMEs to move away from financial reliance on relatives and friends, making it easier for them to raise capital from a broader group of investors, as well as lowering the cost of that capital. This, in turn, permits businesses to expand, to make new investments, to diversify their risk, and to take up new business opportunities.

(c) Public procurement

In most States, public procurement contracts are only available to those businesses that are in compliance with mandatory registration requirements and are part of the legally regulated economy. Access to such contracts may be enhanced for certain groups, since some States have developed specific programmes to ensure that a certain percentage of public procurement contracts are granted to less entitled entrepreneurs, including women, youth, the disabled and the elderly.

(d) Legal validation

Compliance with mandatory registration requirements permits a business to operate legally in the jurisdiction and provides the entrepreneur with documentation proving that status. This status also enables such businesses to have access to justice for commercial purposes, to enter into and enforce contracts more easily, and may facilitate access to exit mechanisms, such as reorganization or liquidation, in the event of financial difficulty. In some legal systems, compliance with all mandatory registrations provides additional legal rights for the entrepreneur operating in the commercial sector, including flexible provisions on commercial contracts, specialized commercial court divisions, a relaxation of certain requirements in terms of legal forms of business, and similar benefits.

[39] See, for example, supra, note 22, pp. 14 et seq.

(e) Legal compliance

While related to the concept of legal validation, compliance with the law can itself be seen as an advantage, since it alleviates entrepreneurial anxiety in respect of operating extralegally, and makes it less likely that fines may be imposed. Being in compliance with the law will also reduce the business' vulnerability to corruption and bribery, and should assist the entrepreneur by providing recourse in cases of tax and other inspections.

(f) Access to flexible business forms and asset partitioning

Through registration, the entrepreneur will be entitled to choose the legal business form available in the jurisdiction that is best suited to his or her needs; ideally, the State will provide for a range of legal business forms for that purpose. Most jurisdictions have at least one legal form that permits the entrepreneur to separate personal finances from business finances; such asset partitioning can be invaluable to a business, particularly if financial difficulty is encountered, as the entrepreneur is not in danger of losing all personal assets, and the value of the business assets can be maximized in the case of reorganization or liquidation. Moreover, the value of a business with separate assets may be greater and can be more readily transferred.

(g) Unique name and intangible assets

Compliance with mandatory registrations often requires an enterprise to operate under a sufficiently unique business name. This unique name translates into a market identity that can develop a value of its own and be traded to a subsequent owner. Other intangible assets that can add to the value of a business and be traded, particularly in the case of asset partitioning and a separate legal business identity, include client lists and commercial relationships.

(h) Opportunities for growth

In addition to the advantages of visibility set out above, compliance with mandatory registration requirements, including with the business registry, provides an enterprise with access to a much larger business network, which can permit it to grow the business and operate it on a much greater scale. Some States permit a business that has fulfilled its legal requirements to become a member of the Chamber of Commerce or other trade organization, which can greatly enhance an enterprise's opportunities for development.

(i) Opportunities for specialization of labour

Businesses that have complied with their mandatory registration requirements tend to be less constrained in their hiring practices and may be able to recruit employees outside of family and friends. This can facilitate access to a larger pool of talent and permit specialization among employees, enabling the MSME to make better use of employee talents and improving overall productivity.

(j) Access to government assistance programmes

Many States provide specific assistance programmes for MSMEs or for specific types of disadvantaged entrepreneurs. Operation in the legally regulated economy will usually permit an enterprise to access all forms of government assistance available to such businesses.

(k) Empowerment and emancipation effects

The operation in the legally regulated economy of businesses that are owned by women, youth, the disabled, the elderly and other less advantaged groups may have important empowerment and emancipation effects. This may be particularly so in respect of women entrepreneurs, many of whom are micro-entrepreneurs that are often exposed to greater risk as a result of corruption and abuse of authority.

(l) Longer term gains

The visibility of a business operating in the legally regulated economy can also be the main conduit for its growth into cross-border trading. It is also possible that, in the longer term, and particularly through the use of electronic commerce and Internet facilities, robust compliance of businesses with mandatory registration requirements may lead to an increase in cross-border trading and foreign investment — advantages not only for the enterprise, but for the State as well.

2. Communication and education

37. Communication of, and education on, the advantages of legal and policy reforms undertaken by the State to assist MSMEs will be key to the success of those reforms. While this might seem a relatively small detail, in the context of States and regions in transition or with remote areas, all potential entrepreneurs may not be well-served by mass media or have dependable and regular access to telecommunications or the Internet. In such contexts, the potential obstacles to communication and education, and thus to the success of the reforms, can be expected to be more numerous.

38. An additional consideration for a State in developing communication and education strategies should be the literacy challenges faced by many micro-entrepreneurs and the particular steps that may need to be taken to overcome this hurdle. For example, pictograms could be used in addition to text in order to inform potential businesses of the programmes and advantages offered to them. Additional options could include using other culturally significant means of communicating with such groups, including through songs and storytelling. One example demonstrates how,[40] in order to publicize its programmes aimed at fostering micro entrepreneurs, a State launched a national campaign illustrating the benefits of those programmes by way of radio and television broadcasts of a simple and interesting scenario using well-known national actors performing in the national languages of the State.

39. In designing its communication and education plan, a State must be cognizant of the potential impediments outlined above and think practically about how best to overcome such difficulties. Possible solutions could include:

(a) Providing mobile education and communication efforts, and for mobile registration and facilitation counters, so as to enable travel to the entrepreneur's location;

(b) Using trade organizations or informal workers' associations to assist in publicizing the programmes;

(c) Using mass media that is broadly available, including radio, television and print media, as well as posters and billboards;

(d) Making blanket announcements via text on mobile phones; this may be particularly effective in areas where mobile payments are being used;

(e) Ensuring communication and education is in the local language;

(f) Making use of social media: while less practical in terms of States that face technological hurdles, social media may be an effective tool, particularly to disseminate information among younger entrepreneurs and family members;

(g) Developing courses for gender-specific trading or involving other disadvantaged groups; and

[40] See, for example, efforts of the Democratic Republic of Congo in publicizing its OHADA (Organisation pour l'Harmonisation en Afrique de Droit) "entreprenant" programme (www.ohada.com/actualite/2609/ohada-rdc-campagne-mediatique-de-sensibilisation-sur-l-entreprenant-communication-de-la-commission-nationale-ohada-de-rdc.html). A sample video may be viewed here: www.youtube.com/watch?v=lE1OIo1eNtc.

(h) Using educational techniques that may be particularly useful in the context.[41]

B. Making it desirable for MSMEs to operate in the legally regulated economy

40. Another component of the communication package that should be conveyed to prospective businesses is clear information on the incentives a State provides to MSMEs to encourage them to participate in the legally regulated economy. It is important that businesses are made aware of such incentives and that they outweigh the perceived advantages of operating in the extralegal economy.

41. The effectiveness of the incentives offered by the State will vary according to the specific economic, business and regulatory context. While it is not possible to specify precisely which incentives should be offered, States may wish to consider the incentives outlined in the following paragraph, each of which, often in combination with others, has been found to be an effective means of encouraging MSMEs to enter the legally regulated economy. In addition, in planning for the creation of these incentives, States may need to ensure coordination with international organizations active in this area (including, for example, the World Bank Group, UNCTAD, UNIDO, the Asian Development Bank, or OHADA), officials of public authorities with which businesses must register, local business incubators, the tax authority, and banks in order to maximize the impact of the incentives chosen.

42. A State may consider programmes along the following lines: [42]

(a) Simplification of the registration process for businesses;

(b) Assistance with the registration process for businesses;

(c) Free (or at least very low-cost) registration;

(d) Receipt of an official certificate indicating the registered status and legal form of the business;

(e) Organized access to and support with banking services (bank accounts and chequing accounts);

(f) Easier access to credit for businesses operating in the legally regulated economy;

(g) Accountancy training and services, and ensuring simplified accounting rules suitable for MSMEs;

(h) Assistance with the preparation of a business plan;

(i) Training (including managing inventory and finances);

(j) Tax and other credits for training costs;

(k) Protection against potential administrative abuse, possibly through access to mediation or other dispute resolution mechanisms;

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[41] One such method may be "participatory learning and action", which has been described as an approach traditionally used with rural communities in the developing world. It combines participatory and visual methods with natural interviewing techniques and is intended to facilitate a process of collective analysis and learning. The approach can be used in identifying needs, planning, monitoring or evaluating projects and programmes, and offers the opportunity to go beyond mere consultation and promote the active participation of communities in the issues and interventions that shape their lives. See, for example, "What is Participatory Learning and Action (PLA): An Introduction", Sarah Thomas (http://idp-key-resources.org/documents/0000/d04267/000.pdf) or www.iied.org/participatory-learning-action.

[42] The Working Group may wish to note that each of these incentives, and any additional ones suggested for inclusion, could be described in a brief paragraph, if desired.

(l) Simpler and more equitable taxation (lower, simplified taxation rates), including tax mediation services and simplified tax forms;

(m) Business counselling services;

(n) A transition period to give new businesses time to comply fully with applicable laws;

(o) A temporary "tax holiday" for small and microenterprises upon their initial registration with the necessary public authorities;

(p) Lump sum monetary compensation or government subsidies and programmes[43] to foster MSME growth;

(q) Public communication and promotion of the business, as well as networking opportunities and access to experienced businesses, for example through free memberships in industry organizations;

(r) Specific public procurement programmes to encourage small and micro-businesses or those owned by disadvantaged groups to have access to contracts;

(s) Low-cost technological infrastructure;

(t) Access to and support with obtaining health insurance; and

(u) The establishment of a business mentoring programme with experienced business owners to facilitate access to experience and information for MSMEs.

C. Making it easy for MSMEs to operate in the legally regulated economy

43. In addition to a lack of information, one of the most often-cited reasons given by MSMEs for their reluctance to operate in the legally regulated economy is the cost and administrative burden of doing so. Two areas of reform that States may undertake to assuage these concerns are to simplify and streamline the procedures necessary for a business to comply with the mandatory registrations with public authorities, focussing on the needs of the user, and to provide flexible and simplified legal business forms for MSMEs.

1. Simplified and streamlined registration for businesses

44. One aspect of making it simple and desirable for an MSME to operate its business in the legally regulated economy is to take a user-centric approach and to make the procedures for mandatory registrations with public authorities, including business registration, accessible, simple and clear. Improvements made by a State to its registration system may be expected to assist not only MSMEs, but businesses of all sizes, including those already operating in the legally regulated economy. Importantly, care must also be taken to effectively communicate these changes and their advantages to MSMEs and potential entrepreneurs throughout the jurisdiction.

45. The draft legislative guide on key principles of a business registry (A/CN.9/WG.I/WP.109) explores in detail the steps that can be taken by a State to simplify, streamline and adopt good practices in its system of business and other registration.

2. Flexible and simplified business forms for MSMEs

46. Another aspect of creating an enabling legal environment and an attractive business environment for MSMEs is for the State to permit them simple access to flexible, legally recognized business forms. Many micro and small businesses are either sole proprietorships or family enterprises that do not possess a legal identity or

[43] For example, some States have programmes to encourage young nationals who have been educated abroad to return to their State and start businesses.

a business form distinct from that of the owner. An entrepreneur should be permitted to easily and inexpensively register a business with a legally recognized form in that jurisdiction. States may wish to permit registration of a range of different legal forms so as to provide entrepreneurs with sufficient flexibility to meet the needs of MSMEs, and to foster their growth.

47. For some businesses, operation as a simple sole proprietor may be sufficient for their purposes. However, some States and regional economic organizations have created a legal business form for individual entrepreneurs (defined as those whose business turnover is below a certain amount) which adds certain benefits to those otherwise available to the sole proprietor.[44] These benefits tend to include being subject to a simplified scheme for the calculation and payment of taxes and social security contributions, as well as fast, simplified and low (or no) cost registration requirements and formalities. In addition, States may also adopt a number of incentives available to such businesses which may include: assistance in opening a bank account and gaining access to banking services, access to mediation services (for example, in respect of taxation and legal services) and practical training and advisory services in key business areas (for example, in accounting, management and inventory, legal and tax obligations, financial education and awareness, business planning, and restructuring and growth strategies). Nonetheless, such schemes typically do not change the unlimited personal liability of a sole proprietor, whose personal and professional assets are all available to meet any business debt.

48. An important business right that should be offered to MSMEs is the opportunity for an enterprise to partition its business assets from the personal assets of its owner(s). The legal ability of an enterprise to partition its business assets from the personal assets of its owner(s) is an important building block for the encouragement of entrepreneurial activity since, even though a business may fail, the personal assets of the entrepreneur(s) will be protected.

49. Asset partitioning is seen as one of the defining features of a limited liability business entity, which is said to be among the most productivity enhancing legal institutions available. Offering entrepreneurs the opportunity to take on legal personality and limited liability through the adoption of a simplified business form is certainly a feature that States should consider in making policy decisions on legal forms to adopt in order to reduce the legal obstacles encountered by MSMEs. The key issues involved in adopting a legal regime for simplified business entities with these features, but adapted for MSMEs (including sole proprietors), is considered in detail in the draft legislative guide on an UNCITRAL limited liability organization (A/CN.9/WG.I/WP.99 and Add.1). However, it should be noted that the benefits of asset partitioning for MSMEs registering their businesses may also be available in a legal structure that stops short of full limited liability and legal personality, and is thus subject to fewer formal requirements.

50. One such model that has been adopted is that which permits an individual entrepreneur to officially allocate a certain share of personal assets to the entrepreneur's professional activity. This approach permits the entrepreneur to segregate professional assets from personal assets so that, in the event of financial difficulty of the business, creditors will have access only to the professional assets of the entrepreneur.[45]

51. Another model that has been used in this regard is the establishment of a separate capital fund that has been established for a specific purpose. Such a fund may be established by individuals (and their spouses), into which specific assets can be placed

[44] See, for example, the "entrepreneur with limited liability" (EIRL) or the "auto-entrepreneur" in France (A/CN.9/WG.I/WP.94 and A/CN.9/WG.I/WP.87, paras. 22-23, and pp. 10 et seq., respectively), or the "entreprenant" in OHADA, Acte Uniforme Révisé Portant sur le Droit Commercial General, adopted 15 December 2011, entry into force 16 May 2011 (www.ohada.com/actes-uniformes/940/acte-uniforme-revise-portant-sur-le-droit-commercial-general.html)

[45] See A/CN.9/WG.I/WP.87, paras. 26–27

that are identified as necessary for the family requirements of the individuals. Such assets are then protected from seizure in the case of business insolvency. A variation on this model may also be created by a corporation, which can establish a separate capital fund devoted to a specific purpose or which can agree that the earnings of an activity be dedicated to the repayment of loans obtained for the execution of certain specified activities. The establishment of such a fund is subject to certain requirements, including that its existence be made public by way of the business registry, and that it be open to opposition by existing creditors of the corporation. Once the fund is constituted, it is segregated from the other funds of the company, and may only be used to satisfy the claims of creditors arising as a result of the relevant activities. Other variations on the creation of a segregated fund may include the declaration of the fund to a specific purpose to the benefit of a natural or legal person, a public administrative body, or other entity, provided that the fund is established by public deed and is registered.[46]

52. An additional example of asset partitioning that stops short of providing legal personality and limited liability is the concept of "business network contracts". This legal tool can be used by a group of entrepreneurs (of various types and sizes, including sole proprietors, companies, public entities, and non-commercial and not-for-profit entities) who undertake a joint venture as agreed in the business network contract, which may be in respect of certain services or common activities within the scope of their business, or even with respect to the exchange of information. The goal of such an approach is to strengthen the individual businesses involved in the contract, as well as the network itself, at the national and international levels, so as to enable access to business opportunities not available to an individual enterprise, and thus to improve competitiveness. The contract must meet the formal requirements established by the State (for example, be duly executed in writing, indicate the objectives of the venture, its duration, the rights and obligations of participants, etc.), and be registered with the business registry. In addition, the contract must establish a capital fund to carry out the programme of the business network; this fund is then segregated from the individual assets of the founding entrepreneurs, and is available only to satisfy claims deriving from the activities performed within the scope of the network, and not for creditors of the individual entrepreneurs that created the business network.[47]

[46] See A/CN.9/WG.I/WP.87, paras. 2–7.

[47] See A/CN.9/WG.I/WP.87, paras. 8–17.